CABLE SERVICE PROVIDERS' COMMENTS ON MTC PROPOSED UNIFORM REGULATION FOR APPORTIONMENT OF INCOME FROM THE SALE OF TELECOMMUNICATIONS AND SIMILAR SERVICES

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INTRODUCTION

Sutherland Asbill & Brennan LLP and KPMG LLP respectfully submit the following comments on behalf of a group of taxpayers that engage in the provision of cable and other services (the "Cable Service Providers"), in response to the MTC's Proposed Uniform Regulation for Apportionment of Income from the Sale of Telecommunications and Similar Services (the "Proposed Regulation"). This white paper is intended to provide information and technical analysis supporting the Cable Service Providers' contention that the Proposed Regulation should not be adopted, or in the alternative should not be applied to the services described below.

The Cable Service Providers concur in and support comments and presentations previously submitted by members of the telecommunications industry, which question the need for the Proposed Regulation and the merits of many of its provisions. Additionally, the Cable Service Providers submit that the Proposed Regulation unfairly requires widely disparate businesses to source receipts using a method that does not reflect the manner in which they earn income or the extent of their business activity in the various states. The Proposed Regulation abandons well-established sourcing rules for providers of cable, data services, and other services, without a demonstrated need for such a change.

The MTC has not articulated a telecommunications industry-specific apportionment problem. The proposed "telecommunications and similar services" scope of the Proposed Regulation continues the disturbing trend of discriminatory isolation of those industries which form the backbone of our modern information economy. The policy reasons advanced in favor of this change have no special affinity to telecommunications or Cable Service Providers versus all other service providers. These changes meet the standard of fairness and equity only if applied equally to all service providers.

Most states require corporate taxpayers to apportion business income among the states in which they do business. Apportioning income is often accomplished in part by multiplying business income by a fraction consisting of in-state sales divided by all sales. Many states require service industries to use a "Costs of Performance" ("COP") rule to apportion services receipts, whereby a seller of services computes "in-state" sales based on the jurisdiction in which the majority or a proportionate share of its costs to provide the service are incurred (as opposed to where its customers are located).

After years of experience in applying the COP rule, Cable Service Providers are convinced that the current COP sourcing regime used by most states fairly apportions income earned by Cable Service Providers to the states in which the income is actually earned. The COP

rules are well understood and offer an administrable and auditable method of apportioning income.

The MTC's Proposed Regulation is intended to effect a sea change in state income tax sourcing rules that apply to receipts from a broad range of so-called "telecommunications and similar services." For purposes of the MTC's Proposed Regulation, "similar services" are defined to include (but not be limited to) information services, provision of telecommunication network access, information service, cable or satellite television or radio programming distribution, Internet access service, web search portals, and data processing. This listing of services goes beyond what most would consider telecommunications services. This broad listing of services that are allegedly "similar" to telecommunications services will apply to a substantial number of service businesses that, in fact, bear little or no relation to telecommunications services – and in many cases, little or no relation to each other.

Providers of telecommunications services would be required to apportion sales on a transaction-by-transaction basis, according to the location of the customer. As this white paper demonstrates, it is often difficult to apply transaction-by-transaction service-address sourcing rules to many services performed by Cable Service Providers, and the location of the customer may not fairly reflect the state where the provider earned income from its services.

Cable Service Providers would like to offer the following observations with respect to the traditional COP rule and the MTC's Proposed Regulation, each of which are more fully discussed, *infra*:

The MTC's Proposed Regulation is inappropriate and should be rejected for a variety of reasons:

- COP is a well-established method for sourcing receipts of all services and it reasonably reflects the Cable Service Providers' business activity;
- Only minor adjustments (not a complete overhaul) would be required to address any perceived inadequacies in the current COP rule, as applied to all services but particularly as applied to "similar services;"
- The Proposed Regulation is overly broad because it applies to any service that *may* be bundled with telecommunications service, regardless whether such bundling actually occurs;
- A variety of general policy concerns arise when transaction-tax sourcing concepts are utilized to source receipts for income tax purposes; and
- A variety of legal concerns are triggered by the MTC's Proposed Regulation.

If the MTC's Proposed Regulation *is* ultimately applied to telecommunications services, then "other services" should not be included in this MTC sourcing project:

- The various features that differentiate cable service from telecommunications service render the MTC's proposed service-address sourcing concept/rule unworkable for Cable Service Providers and other providers of "other similar services."

Section I of this paper describes a few of the services offered by Cable Service Providers – with specific reference to the income producing activities associated with each – potentially governed by the Proposed Regulation. Section II of this paper sets forth the Cable Service Providers' numerous objections – founded on technical, policy, and legal analysis – to the Proposed Regulation, as applied to the services described in Section I. The paper ultimately concludes that if the MTC wishes to design a new regulation for purposes of sourcing receipts from telecommunications services, then it should cast such an effort in terms of a special Public Participation Working Group and involve all service providers in a discourse on the propriety and efficacy of a special industry apportionment rule, such as others that the MTC has proposed (*e.g.*, the UDITPA Section 18 special apportionment rules for financial institutions and the transportation industry). If the MTC is not focused on solving a *telecommunications industry-specific* apportionment problem, then it should articulate its goal as being the introduction of a new apportionment rule for use by *all* service providers, regardless of industry. Once the MTC has articulated its particular concerns and identified its precise goals for this Proposed Regulation, then service providers and their representatives can meaningfully frame, understand, and participate in the discourse.

I. DESCRIPTION OF SERVICES PERFORMED BY CABLE SERVICE PROVIDERS

A. Cable Services

1. Overview: Cable's Place in the Video Services Market

Cable operators provide a broad array of programming distribution packages to nearly 67% of U.S. households.[1] In recent years, broadband technology has allowed cable operators to expand their video services to include more than just pre-packaged programming distribution. These new services include enhanced video services such as pay-per-view, video-on-demand, high definition television, and interactive television. According to the National Cable and Telecommunications Association ("NCTA"), cable operators have invested nearly $95 billion in infrastructure upgrades since 1996 to provide new broadband services to customers in more than 105 million homes.

There are numerous cable operators throughout the country. The top ten cable operators (by reference to subscribers) at the end of 2004 included:[2]

- Comcast
- Time Warner Cable
- Cox Communications
- Charter Communications
- Adelphia
- Cablevision
- Bright House Networks
- Mediacom Communications Corp
- Insight Communications
- CableOne

Competition in the video services market has been steadily increasing. Today, customers can choose from a variety of multichannel video providers other than cable operators, including:

Digital Broadcast Satellite (DBS) – Similar to cable operators, DBS companies (e.g., DirecTV and EchoStar) offer customers hundreds of channels in various packages, including local broadcast signals into their origin market (i.e., local-to-local signals). Only two cable companies (Comcast and Time Warner Cable) have more subscribers than DirecTV.

Alternative Broadband Providers – Companies such as RCN/Starpower, Knology and WideOpenWest are able to provide video programming services, including video-on-demand.

[1] A.C. Neilsen Media Research.
[2] NCTA Top 25 MSOs List.

Telephone Companies – Regional Bell Operating Companies have entered the video market by offering to supply customer with video content both on their own and in partnerships with DBS providers.

Utility Companies – Utility companies, such as Sigecom and Seren Innovations, have entered the video services market by using the right-of-ways associated with traditional utility services to lay cable to provide video services, including multichannel video programming, to customers.

As a result of competition in the video services market, Cable Service Providers have increasingly tried to differentiate themselves by offering new and customized programming, new services and new technology tools.

2. Video Content Delivery

Cable Service Providers deliver video content to their subscribers. The "old time" view of the function of a Cable Service Provider was that it acquired video content from third parties and then merely retransmitted that signal to its subscriber. The typical example of this model is the analog signal of the local broadcaster. That signal comes into the cable headend and is merely retransmitted to the cable subscriber.

However, Cable Service Providers have moved into the digital age. This simple retransmission scenario currently represents less of the value-added service they provide to the subscriber. Cable Service Providers must make material enhancements to and manipulation of the content they acquire from programmers and offer additional value-added services (*e.g.*, D.V.R.S.) to stay competitive. One example of this shift is the conversion of analog signals to a digital format for purposes of migration to a digital cable service. A second example involves the offering of on-demand storage and retrieval services whereby Cable Service Providers store, index and catalog content so that content can be accessed by the cable subscriber at any-time. Cable Service Providers have invested significant amounts in equipment for the production of advertising content, as well as significant network call and data center infrastructure needed to support the monitoring, billing and security of all these services.

Content is generally sold to subscribers in packages (e.g., all local channels), on a per-use basis (pay-per-view or on-demand services), or subscribers may purchase subscriptions to premium programming such as HBO or Showtime. The exact geographic network configuration that Cable Service Providers use to distribute video content to subscribers varies depending upon the particular Cable Service Provider. However, the following is one typical example of the manner in which video content is delivered.

Once video content is procured or produced, it is sent to a satellite owned by the Cable Service Provider or leased from a third party. The satellite transmits the content to "headends" located at various points throughout the Cable Service Provider's service area. A high-speed terrestrial data line is an alternative means of delivering the content to the head end. The headends may or may not be in close proximity to the customer depending upon the density of

the customer base. An industry trend is towards headends which service larger (often multistate) areas. The headend acts as an aggregation and distribution point, routing the video content to various hubs located throughout a cable service area. The hubs then route the content to a customer's location via a Hybrid Fiber Coax (HFC) distribution system. Coaxial cable, the cable that runs through most homes, branches off from the fiber optic receiver (Node) in the customer's neighborhood into "feeder" cables that carry signals to each street. The final connection is made with the "drop" cable, which plugs into the customer's converter or directly into a customer's television.

Today, converters often must be purchased or leased by the subscriber to allow for the receipt of video programming and the purchase of various types of content and services. The trend is towards all digital networks so the prevalence of converters will increase. An important fact to note is that the converter is not a self-contained unit. When a subscriber orders a pay-per-view or on-demand offering, the converter must communicate with the headend and the headend then must communicate with the billing data center. The critical elements to the order and the provisioning of service are not all situated within the subscriber's home. To the contrary, the data center, the headend, and (if an advertisements are involved) the advertising insertion equipment are all involved. It is important to note that the data center, headend and add insertion equipment are often located at three geographically separate locations on the network.

A Cable Service Provider's infrastructure costs in a state may or may not be in relation to the number of subscribes in a state. For example, in sparsely populated areas, a Cable Service Provider's infrastructure cost can be substantially greater than in a densely populated area. However, for many cable systems once a cable operator reaches a certain number of subscribers, its infrastructure costs generally increase in proportion to the number of subscribers added.

3. Content

As noted above, the cable business has become increasingly competitive over the past several years. To effectively compete for subscribers, cable operators must secure and deliver attractive programming and develop program packages to attract end users. Each year cable operators must choose from hundreds of programs supplied by an increasingly large number of broadcasters to assemble their content menus or packages.

Once content is procured from third parties, programming contracts must be negotiated and maintained with each content provider and the cable operator must monitor and ensure that the correct programming is delivered. The value of content and the activities associated with accessing and distributing the content are critical value drivers in the cable business.

As opposed to telecommunication services, which constitute mere "transparent transmission,"[3] the video services provided by cable operators involve the delivery of entertainment. The Cable Service Providers deliver programming packages and related services

[3] The Supreme Court recently affirmed the FCC's conclusion that telecommunications service involves the "transparent transmission" of information. *See* National Cable and Telecom. Assoc. v. Brand X Internet Services et. al., 2005 WL 1498860 (2005).

that educate, inform and entertain viewers – in other words, it is the content that purchasers primarily seek from Cable Service Providers, not the transmission of same. Providing the right programming *content* is critical in attracting and retaining video customers.

In order to obtain and provide this content, Cable Service Providers are required to incur ever-increasing expenses. Over time, increased content expenses have driven increases in the price of cable services.[4] Unlike the expenses associated with telecommunications transmission services, which are essentially flat and therefore reflected in "commodity"-type pricing models (i.e., the lowest price generally attracts the greatest number of customers), Cable Service Providers compete with each other on the basis of additional factors besides price. And, while these factors include the availability of leading-edge technology (DVRs, HDTV, etc.) and the ability to provide service bundles to subscribers, a dominant factor in competitiveness of a Cable Service Provider is the perceived breadth and quality of its content offerings.

4. Expenses to Provide Service

Cable Service Providers incur numerous expenses in delivering services to customers. These expenses include costs to produce and/or procure programming, plant, and equipment to deliver the programming and employee costs to run the business. For many Cable Service Providers, the costs to procure, produce, monitor, and maintain programming represent the largest expense in delivering video content to subscribers. The costs of procuring and maintaining plant and equipment also constitute a significant expense for Cable Service Providers. As discussed above, depending upon the Cable Service Provider and the types of service offered in a given market, these costs may or may not be in proportion to a Cable Service Provider's customer base.

B. High Speed Data Services

Subscribers seeking high-speed access to the Internet may select from several technologies. Two of the more predominant technologies are DSL and cable modem access. As the Internet has evolved, Internet service providers (ISPs) now offer subscribers various content as part of the standard monthly fee. This content may include services such as spam protection, anti-virus and spyware protection, child protection features, and on-line mailboxes. Additionally, ISPs often provide access to proprietary content such as sports information, books and magazines and updates on current events. The type of proprietary content and the types of services provided to subscribers varies significantly.

For customers using cable modem service to access the Internet, customers must access Cable Service Providers' regional data centers using a computer and modem. The data centers combine various types of cable/computer infrastructure capable of storing, routing and

[4] On February 4, 2005, the Federal Communications Commission (FCC) released its annual report on cable industry prices. The report indicated that the overall average monthly rate for cable service -- including basic and expanded basic cable programming services and equipment -- increased by 5.4 percent over the 12-month period ending January 1, 2004, from $42.99 to $45.32. The price increases reflected in this report are representative of historical trends in the pricing of cable services. A full copy of the report is available at www.fcc.gov/mb.

monitoring the data that is sent to and from customers. The data centers are typically centralized, e.g. each data center (located in a single state) aggregates the activity from numerous states.

To access these data centers, the customer's Internet traffic travels over Cable Service Providers' cable facilities. The data centers are connected to Internet gateways, which may be owned by the Cable Service Providers or third parties, where Internet traffic is directed or exchanged. The data centers and Internet gateways are part of what is commonly referred to as the Internet. To facilitate the transmission of Internet traffic from a Cable Service Provider's data centers to the Internet gateways, the Cable Service Provider may procure telecommunications services or Internet services from third-party network service providers.

To provide high-speed Internet services, a cable operator sends and receives data over its hybrid fiber/coax (HFC). This HFC is linked to the regional data centers where the ISP maintains its Internet servers. To deliver data services over a cable network, one television channel (in the 50 - 750 MHz range) is typically allocated for downstream traffic to homes (information from a website that is sent to the subscriber) and another channel (in the 5 - 42 MHz band) is used to carry upstream signals (information requests from the customer that are sent to a central server(s)). More channels may be allocated to the high-speed internet service as Cable Service Providers increase the per-megabit speed of their offerings.

A key aspect of high-speed Internet access is that customers are paying for the transmission and receipt of information and services as opposed to mere transmission services. The Supreme Court recently acknowledged that high-speed Internet access services involve something substantially different from mere transmission.[5] In Brand X, the Court upheld the FCC's interpretation that cable modem service is an information service because it provides customers with the ability to manipulate information including browsing the World Wide Web, transferring information, accessing and storing email and many other services. In determining where income from high-speed data services should be sourced, one cannot merely look to the location off the pipes and wires that transport the information. The Court refers to these as "transparent telecommunications." Conversely, one must look to where the Cable Service Providers incur their costs to provide this information service. To source the income from high-speed data services based on the locations of subscribers would be to fail to acknowledge the contribution of the states where significant value is created.

The Cable Service Providers incur significant costs to provide high-speed data service to subscribers. These costs include costs attributable to regional data centers, costs attributable to infrastructure leading up to the customer's premises and the costs of additional services and content typically provided as part of the Cable Service Provider's high speed data network service. The regional network data centers aggregate subscriber activity from numerous states and thus the state(s) in which these centers are located typically have a higher percentage of costs and account for a higher percentage of the benefit delivered to a subscriber.

[5] National Cable Telecom. Assoc. v. Brand X Internet Services et. al., 2005 WL 1498860 (S. Ct. 2005).

To the extent that Cable Service Providers provide Voice over Internet Protocol ("VoIP") services, and states characterize VoIP as a "telecommunications service,"[6] Cable Service Providers are competing with other telecommunications service providers and are engaged in the provision of a service that more closely resembles the types of services that the MTC's Proposed Regulation purports to address. Thus, to the extent that Cable Service Provider's VoIP services have been addressed by other telecommunications industry representatives before the MTC's Income and Franchise Tax Uniformity Subcommittee, the Cable Service Providers endorse those previous explanations of the technology and service delivery models. With respect to telecommunications services alone, Cable Service Providers and telecommunications service providers may be considered equivalent for income tax sourcing purposes.

II. SUBSTANTIVE COMMENTS ON THE MTC DRAFT PROPOSED REGULATION

A. Background: Current Regime For COP Sourcing Of Receipts From The Sale Of Services

As noted in the preeminent state taxation treatise, the sales tax factor contained in the Uniform Division of Income for Tax Purposes Act ("UDITPA") was grounded equally in political and in theoretical considerations regarding the proper method to divide net income taxes among the states:

> The sales factor – with the sale destination test – is justified as much by political as by economic considerations. The economic justification for the other two factors – property and payroll – is clear enough. "Income," we were told long ago, "may be defined as the gain derived from capital, from labor, or from both combined.". . . The sales factor, by contrast, attributes income to states in which goods are consumed and serves as a counterbalance to the property and payroll factors which tend to attribute income to states in which goods are produced.

Hellerstein & Hellerstein, I State Taxation: Constitutional Limitations and Corporate Income and Franchise Taxes, ¶8.06[2] (internal citations omitted).

However, this explanation is incomplete as relates to sales of other than tangible personal property. The drafters of UDITPA acknowledged that the sales factor worked best for sales of tangible goods, but was not suitable for most other types of businesses:

> In fact, by its original terms, UDITPA applies only to taxpayers "having income from business activity… other than activity as a financial organization or public utility *or the rendering of purely personal services*."

Id. at ¶10.01 (citing UDITPA §2; emphasis added).

[6] *See* SSTP definition of "telecommunications service," *infra*.

As a result, states and the MTC have stepped into the void to design (i) special apportionment rules for particular industries within the service sector, and (ii) statutes and regulations that adapt the standard apportionment rules to the service sector in general.

By reference to the latter category of responses to the insufficiencies of UDITPA, states generally source receipts from sales of services by using either an income producing activity/costs of performance test or a market state approach. A market state approach typically looks to the location of the customer for sourcing determinations, and therefore more closely resembles the UDITPA sourcing rule for sales of tangible goods. Under an income producing activity ("IPA") test, the location of the activity generating the revenue—as measured by the entity's costs of performance ("COP") —determines where the revenue should be sourced. Most states employ some variation of the IPA/COP sourcing precept.

Like most widely used apportionment methodologies, the income producing activity test was eventually incorporated into UDITPA Section 17. Although UDITPA's drafters reviewed an array of objections to the IPA/COP methodology at the time of its adoption, they concluded "that exceptions for certain types of sales income would have to be established…since no formula seemed to be satisfactory for every possible situation," but "the provisions of Section 17 were the best that could be designed to cover the greatest number of situations that might arise." *Id*. at ¶10.02[2][1] (footnotes omitted).

The MTC adopted and elaborated upon the IPA/COP sourcing methodology in its MTC Regulations. Article IV.17(1) of the MTC Apportionment Regulations provides the following guidance with respect to the IPA/COP sourcing rule:

> Gross receipts are attributed to this state if the *income producing activity* which gave rise to the receipts is performed wholly within this state. Also gross receipts are attributed to this state if, with respect to a particular item of income, the income producing activity is performed within and without this state but the greater proportion of the income producing activity is performed in this state, based on *costs of performance*.
>
> [Emphasis added.]

The MTC's Regulation IV.17 applies to receipts generated as a result of a specific "income producing activity." The MTC Regulations define the term "income producing activity" as follows:

> The term 'income producing activity' applies to each separate item of income and means the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. Such activity does not include transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, income producing activity includes but is not limited to:
>
> (A) The rendering of personal services by employees or the utilization of tangible and intangible property by the taxpayer in performing a service.

(B) The sale, rental, leasing, licensing or other use of real property.

(C) The rental, leasing, licensing, or other use of tangible personal property.

(D) The sale, licensing, or other use of intangible personal property.

MTC Reg. IV.17(2).

When an income producing activity takes place in more than one state, the receipts from such income producing activity are attributed to the state having the greatest proportion of the income producing activity as measured by "costs of performance." MTC Reg. IV.17(4)(b). "Costs of performance" are defined as follows:

> direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer.

MTC Reg. IV.17(3).

Thus, under MTC regulations in force today that interpret and apply UDITPA to multistate taxpayers, the following determinations must be made in order to source receipts from sales of other than tangible property:

(1) What is/are the income producing activity/ies?;

(2) What are the costs of performance attributable to each income producing activity?; and

(3) Where does the taxpayer incur the greatest proportion of the costs of performance for each income producing activity?

B. MTC Proposal to Substitute New and Distinct Sourcing Rule For Apportionment of Income From The Sale of Telecommunications And Similar Services

Regardless of its previous role in promoting and enforcing UDITPA principles, the MTC is now critical of the established COP method of sourcing and seeks an alternative approach. Many observers believe that the MTC has concluded that the IPA/COP sourcing regime does not distribute receipts from the sale of services to its member states in the same proportion as a "market state"-sourcing sourcing regime. However, the MTC has made the decision that "baby steps" toward such a market state-based sourcing rule will be more acceptable to taxpayers and states that currently apply the COP rule. Therefore, the new rules purportedly apply only to a class of providers defined as "telecommunications and similar providers," while the existing COP rules will continue to be prescribed for other industries. However, as this paper demonstrates, the Proposed Regulation has such a broad sweep – by reference both to defined

terms and to operational features of the new sourcing rule – that it poses a trap for unwary service providers who focus primarily on the "telecommunications service" language.

1. Definitions Are Critical Starting Point in Application of Proposed Regulation to So-Called "Similar Services"

Throughout the MTC Income and Franchise Tax Uniformity Subcommittee's drafting process, the MTC has struggled with how broadly or narrowly to define the group of taxpayers to whom the Proposed Regulation will apply. The Proposed Regulation defines the term "telecommunications or similar services" as follows:

> the provision of any telecommunications, including telecommunications provided by resellers. The term includes, but is not limited to, telephone service, facsimile service, telegraph service, paging service, personal communication services, satellite telephone service, mobile or cellular telephone service, and related fees and ancillary services, including universal service fees, detailed billing service, directory assistance, service initiation, service disconnection, voice mail service, and vertical services, such as caller ID and three-way calling. In addition, the term includes, but is not limited to, the provision of telecommunication network access, information service, voice over internet protocol services, cable or satellite television or radio programming distribution, Internet access service, web search portals, and data processing services.

For purposes of establishing the scope of this new sourcing rule, the Proposed Regulation further stipulates that:

> (i) "communication" means any sign, signal, writing, image, sound or intelligence of any nature including voice, data, text, audio, video, or any other information or instructions.
>
> (ii) "telecommunications" means the electromagnetic transmission, conveyance, routing, emission or reception of communication by or through the use of any medium; including: wires, cables, satellite, microwave, electromagnetic wires, light waves, radio waves, the internet, or any combination of those or other media now in existence or that might be devised. Telecommunications does not include the communication content of any such transmission, conveyance, routing, emission or reception.

At a March 2005 meeting, the MTC circulated various alternative definitions of "telecommunications service." The salient features of each definition are summarized below:

2002 NAICS 517: "Industries in the Telecommunications subsector" are cast as "primarily engaged in operating, maintaining, and/or providing access to facilities for the transmission of voice, data, text, sound, and video." This definition includes "cable and other program distribution," defined as establishments that generally deliver

programming to consumers via cable or direct-to-home satellite systems on a subscription or fee basis, and that do not generally originate programming material.

1996 Communications Act: "Telecommunications" is defined as "transmission, between or among points specified by the user, of information of the user's choosing, without change in the form or content of the information as sent and received." "Enhanced service (a/k/a Information Service)" is defined as "the offering of a capability for generating, acquiring, storing, … information via telecommunications, and includes electronic publishing…."

Alliance for Telecomm Industry Solutions, 2000 Glossary (Federal Standard 1037C): "Telecommunication" is defined as "transmission, emission, or reception of signs, signals, writing, images and sounds or intelligence/information of any nature by wire, radio, optical or other electromagnetic systems."

Streamlined Sales Tax– April 7, 2005[7]: "Telecommunications service" means the electronic transmission, conveyance, or routing of voice, data, audio, video, or any other information or signals to a point, or between or among points. The term "telecommunications service" includes such transmission, conveyance, or routing in which computer processing applications are used to act on the form, code or protocol of the content for purposes of transmission, conveyance or routing without regard to whether such service is referred to as voice over Internet protocol services or is classified by the Federal Communications Commission as enhanced or value added. Telecommunications service does not include:

A. Data processing and information services that allow data to be generated, acquired, stored, processed, or retrieved and delivered by an electronic transmission to a purchaser where such purchaser's primary purpose for the underlying transaction is the processed data or information;
B. Installation or maintenance of wiring or equipment on a customer's premises;
C. Tangible personal property;
D. Advertising, including but not limited to directory advertising.
E. Billing and collection services provided to third parties;
F. Internet access service;
G. Radio and television audio and video programming services, regardless of the medium, including the furnishing of transmission, conveyance and routing of such services by the programming service provider. Radio and television audio and video programming services shall include but not be limited to cable service as defined in 47 USC 522(6) and audio and video programming services delivered by commercial mobile radio service providers, as defined in 47 CFR 20.3;
H. Ancillary services; or
I. Digital products delivered electronically, including but not limited to software, music, video, reading materials or ring tones.

[7] The definition shown herein is updated from the version considered at the MTC's March 2005 meeting.

The SSTP defines a number of traditional subcategories "telecommunications service" and ancillary service. A member state can use these subcategories alone or in combination with other subcategories to define a narrower tax base than the definitions of ancillary services and telecommunications service would imply. A member state may also use the subcategories to provide exemptions for certain subcategories of the more broadly defined terms.

During a June 22 teleconference of the Uniformity Subcommittee, the MTC participants discussed the relative merits of these definitions and agreed to amend the draft Proposed Regulation to more closely reflect the SSTP definition of "telecommunications service." The MTC participants also clarified their view that the services currently under examination for purposes of the proposed regulation should fall into one of three buckets: (1) "pure" telecommunications (by reference to the core definition of same); (2) "related" telecommunications services (also referred to as "ancillary services," by reference to the SSTP definition, albeit the SSTP definition specifically excludes ancillary services from its definition of "telecommunications service"); and (3) "similar services," which pursuant to the current MTC definition include, but are not limited to, information services, VoIP, cable or satellite television or radio programming distribution, Internet access, and data processing services.

Some MTC participants acknowledged and agreed that services that provide end users with content should not be considered under the proposed regulation. All MTC participants indicated that the overarching goals of this regulatory exercise needed to be established, in order to determine which of these buckets ought to be included under the proposed regulation, what additional services might fall under one of these three buckets, as well as whether certain enumerated services should be shifted to different buckets or removed from the scope of the Proposed Regulation altogether.

2. Impact of Bundling on Sourcing

During the March 2005 meeting, the MTC discussed how to source receipts for non-telecommunications services that are bundled with telecommunications. The suggested approach is both overreaching and unworkable: namely, to source services that **may be** "bundled" with telecommunications services (whether they are in fact sold in a bundle or alone) in the same manner as telecommunications services are sourced. *See* Policy Questions: MTC Telecommunications Apportionment Project, Section II.(6) (dated 2-10-05).

The list of services the MTC believes are subject to this derivative application of its new sourcing rule include:

- Internet access services
- Web search portals
- Data processing services
- Information Services that provide information content (data, news, video, audio, law searches and retrieval, etc)

The question arises whether there is any logical or administrable line that may be drawn between services that *may* be bundled and those that *may not*, when any service provider can offer a discount on a "suite" of its services, regardless whether the services in combination provide any enhanced value to the purchaser thereof, beyond the price break. Cable Service Providers often bundle their distinct services, but they do not always bundle all of their services. How does the MTC purport to apply this rule to a service provider that takes different approaches to bundling in different markets? Does it matter whether the difference is driven by the available technology, or by market research? Are companies developing new services required to ask this question for each new service, if any one existing service is swept into the Proposed Regulation for sourcing purposes? If Cable Service Providers *can* bundle all services they provide today, does the MTC's Proposed Regulation imply that every new service in which they engage will be subject to this sourcing regime, because the new service should be inferred to be part of a bundle?

3. New Sourcing Regime Borrows Sales/Use Tax Sourcing Criteria

The MTC's Proposed Regulation changes the sourcing rule with respect to sales of telecommunications or similar services as follows:

> (vi) Sales Factor Numerator. The numerator of the sales factor shall include all gross receipts of the taxpayer from sources within this state, including, but not limited to, the following:
>
> > A. receipts from charges for providing telecommunications or similar services access in this state. "Telecommunication or similar service access in this state" means the ability to originate or terminate the electromagnetic transmission of a communication from a location within this state. **An example of this type of receipt is a monthly subscriber fee or customer charge for the ability to originate or terminate a communication at a service address located in this state and without regard to the actual amount of communications originated or terminated at that service address.**
> >
> > B. receipts from **charges for telecommunications or similar services not billed on a per-communication or other variable unit basis, if the service address is in this state.** An example of this type of receipt is a fixed charge for unlimited telecommunication or similar service, or for up to a set amount or minutes of telecommunication or similar service.
> >
> > C. receipts from charges for cellular or mobile telecommunications services required to be sourced under the Mobile Telecommunications Sourcing Act, Public Law 106-252, as it may be amended from time to time, if the source, as determined under that act, is in this state; [move – below "F"]

D. receipts from charges for telecommunications or similar services billed on a per-communication or other variable unit basis, if the communication originates and terminates in this state;

E. receipts from charges for telecommunications or similar services billed on a per-communication or other variable unit basis, if the communication either originates or terminates in this state, **and the service address is located in this state**;

F. receipts from any other charges for telecommunications or similar service **if the service address is in this state**.

G. receipts from charges for telecommunication network access if the purchasing interexchange carrier's network traffic originates and terminates in this state; or originates or terminates in this state, **and the interexchange carrier's customer's service address is located in this state**.

[Bold print added for emphasis.]

The Proposed Regulation sources receipts from four of the six above categories of services directly to the service address of the recipient of such services; in addition, the Proposed Regulation provides an example of the first category of services that utilizes the service address of the service recipient as evidence of the includability of sales in the sales factor numerator.

The MTC has incorporated these transaction tax-based sourcing rules into their Proposed Regulation through the following language:

(v) A. "service address" means (i.) the location of the customer's equipment which originates or receives the communication, regardless of the address to which the fee for telecommunication or similar service is billed or from which it is paid.

B. If the location in (2)(v)A of this section is not reasonably determinable, "service address" means the origination point of the signal of the telecommunications or similar service first identified by either the seller's system or in information received by the seller from its service provider, where the system used to transport such signals is not that of the seller.

C. If the locations in divisions (2)(v)A and B of this section are not known, "service address" means the location of the customer's place of primary use as defined in the Mobile Telecommunications Sourcing Conformity Act.

Several of the receipts categories that are to be sourced based upon "service address," rather than COP, specifically reference telecommunications services and concepts (*e.g.*, the

Goldberg v. Sweet[8] transaction-tax sourcing rule, and the Mobile Telecommunications Sourcing Act ("MTSA")). In contrast, *none* of the receipts categories that have been created to date specifically address the distinct features and concepts that pertain to so-called "other similar services." It should come as no surprise to the MTC that providers of "other similar services" will have difficulty in applying these standards.

C. The MTC's Proposed Regulation Is Inappropriate and Should Be Rejected for a Variety of Reasons.

1. COP Is a Well-Established Method For Sourcing Receipts of All Services that Accurately Reflects Cable Service Providers' Business Activity.

The challenges that cable and other similar service providers face today with respect to the COP sourcing rule are essentially the same as those faced by any non-differentiated service provider. Cable Service Providers and other similar service providers have come to terms with how to apply concepts such as "income producing activity," "direct costs," "separate item of income," etc., to their particular business models; thus, they have successfully implemented the system established by the drafters UDITPA and administered by the MTC's own member states. The cable industry is convinced that the COP rules effectively apportion income earned by cable service providers to the states in which such income is actually earned.

The industry is particularly critical of the fact that the MTC has failed to articulate any specific reason why the traditional COP rule has failed to accurately source the receipts of Cable Service Providers. The MTC fails to identify, for instance, any increase in litigation, non-compliance, inappropriate tax planning or other potential "harm" to the tax system. In truth, the facts support an opposite conclusion—the COP rules accurately source the income of this industry. Perhaps the only reason, that the MTC says that COP does not work is because it does not yield what the MTC views as "proper" apportionment of receipts for telecommunications service providers. Even assuming *arguendo* that the MTC's position is correct with respect to sourcing telecom receipts, this position cannot support the extension of a telecommunications sourcing rule beyond that narrow scope of those services. Cable Service Providers provide a wide array of services, some of which bear no relation to telecommunications services, and COP sourcing works for all other activities and services which Cable Service Providers perform.

2. Only Minor Adjustments Would be Required to Overcome Any Perceived Inadequacies With the Current COP Rule.

If the MTC believes that the current COP rules do not accurately apportion the income of telecommunications and similar service providers, there is no need to scrap the entire COP rule. Less drastic alternatives exist to address any perceived shortcomings with COP. For example, the opportunity to use an alternative apportionment formula exists where the current rule does not accurately reflect the business activity and income of any taxpayer in a given state.

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[8] 488 U.S. 252 (1989).

Where the COP rule does not function properly with respect to a particular type of service or item of income, both the taxpayer and the tax administrator have recourse via UDITPA Section 18 to relief in the form of special apportionment formula adjustments (*e.g.*, new factors, different factors, agreed-upon application of COP or other methods for apportioning receipts), as well as more informal agreements with state administrators and auditors regarding sourcing methodologies.

3. The Proposed Regulation Is Overly Broad Because It Applies to Any Service That May Be Bundled with Telecommunications, Regardless Whether Such Bundling Actually Occurs.

As noted above, the MTC continues to grapple with how to define those "telecommunications" services that should be subject to the proposed apportionment method. Several of the definitions under consideration are clearly broad enough to include cable services, information services, Internet Access services and ancillary services. As previously noted, there is no express need to include such a broad array of services in the proposed sourcing rules. The effect of lumping so many "other similar services" in with telecommunications – services that are, in fact, highly differentiated by reference to business models, services provided, activities that support the generation of the service, etc. – is to substitute one allegedly overbroad and cumbersome set of rules and impacts with another.

Cable Service Providers are equally concerned by the bundling concept within the current draft. Not only will non-telecom sales that are bundled with telecom sales be sourced according to the customer location, any non-telecom sale that *may* be bundled with telecom is also to be sourced according to the customer location. The MTC must carefully consider the ramifications of such a rule.

4. General Policy Concerns With Using Transactional Sourcing Rules To Source Income.

The reasons cited as justification for sourcing specific transactions to their destination for sales tax purposes do *not* support using the same method for sourcing for income tax purposes. Income tax operates in an entirely distinct manner from sales tax. Sales taxes are inherently transactional in nature. Rules that determine at what location a specific transaction is subject to tax look closely at the individual transactions. Conversely, income tax does not look at specific transactions to determine in what jurisdiction the income generated from the transaction is subject to tax. Rather, business activity over a particular period is used to approximate the income that is earned within a particular jurisdiction. Such a period approach is more in keeping with the nonspecific nature of an income tax, which cannot always be traced to a definite source.

Sourcing receipts by using the same method used to source specific transactions coupled with the increasingly popular single sales factor apportionment creates an apportionment methodology that more closely resembles a specific allocation than it does a fair apportionment method.

Even if the MTC were interested in pursuing adoption of transaction-tax sourcing principles, these principles are being dramatically altered within the Streamlined Sales Tax Project. For instance, Section 312 of the Streamlined Sales and Use Tax Agreement ("SSUTA") provides for the application of a Multiple Points of Use Exemption, which allows purchasers of services concurrently available in more than one jurisdiction to apportion the sales price. Many data processing and information services will qualify for such treatment. The adoption of MPU concepts by the states is a reflection of the difficulty and inequity in sourcing sales to the location of the customer. It is also worth noting that the Streamlined Sales Tax Project recently adopted a definition of a "bundled transaction." If the MTC is interested in adopting transaction tax concepts within this COP effort, then it is incumbent upon the MTC to evaluate the latest developments and improvements being made to transaction taxation, including Multiple Points of Use treatment and the SSUTA definition of a "bundled transaction."

5. Potential Legal Concerns Are Also Raised By The Proposed Sourcing Regulation.

The first prong of the *Complete Auto Transit* dormant Commerce Clause test requires that a tax only be imposed on an activity with a "substantial nexus" with the taxing State. The phrase "substantial nexus" embodies the concepts of entity nexus and transactional nexus. In addition to requiring nexus for the entity taxed, the Commerce Clause also requires that the transaction to be taxed have a sufficient connection with the taxing state. At issue here is whether the sourcing rule would allow the taxation of a transaction without sufficient connection to the states. The proposed sourcing methodology ignores where an actual transaction takes place by using service address as a proxy for where the actual activity occurs.

D. If the MTC's Proposed Regulation *Is* Ultimately Applied to "Telecommunications Services," Then Other "Similar Services" Are Not Appropriate Subjects for This Sourcing Regime

1. The Various Features That Differentiate Cable Service From Telecommunications Service Render The MTC's Proposed Service-Address Sourcing Concept/Rule Unworkable For Cable Service Providers And Other Providers Of "Other Similar Services."

While Cable Service Providers concur in the criticisms of the Proposed Regulation that the telecommunications industry have raised, Cable Service Providers feel there are additional sound reasons why it is impractical to source cable service receipts in the same manner as telecommunications service receipts. The sanctioned approach under the MTC's Proposed Regulation sources receipts according to the purchaser's service location. However, cable service is interstate in nature. Consumer-based sourcing that ignores the interstate nature of cable service does not accurately reflect where income is earned. It fails to recognize the perhaps more significant contributions of states where services are performed and income is earned.

In Brand X, the Supreme Court upheld the FCC's conclusion that high-speed cable modem services were not telecommunications services as defined by the Telecommunications Act of 1996.[9] In distinguishing cable modem services from telecommunications services the Court highlighted the distinction between telecommunications services which merely transmit information transparently and cable modem services which supply content and information to end users. "The [cable] wire is used, in other words, to access the World Wide Web, newsgroups, and so forth, rather than 'transparently' to transmit and receive ordinary-language messages without computer processing or storage of the message".[10] Furthermore, "Cable companies in the broadband Internet service business 'offe[r]' consumers an information service in the form of Internet access and they do so 'via telecommunications,' § 153(20), but it does not inexorably follow as a matter of ordinary language that they also 'offe[r]' consumers the high-speed data transmission (telecommunications) that is an input used to provide this service . . ."[11]

Based on the Court's findings in Brand X, to the extent broadband Internet services are included in the Proposed Regulation, arguably all services which provide end users with information and which use telecommunications to deliver such information should be included under the Proposed Regulation. To not include such services would lead the arbitrary distinction of subjecting some information services to market based sourcing rules while other types of information services remain subject to traditional COP sourcing methodologies.

For example, Cable Service Providers seldom receive all of their revenue from the provision of cable services. A typical large provider receives revenue from a number of different sources. If the MTC chooses to advocate the elimination of COP sourcing with respect to telecommunications service, it is important that the COP rule remain in place for these other services. The rule should not require (or be inferred to require) a single apportionment methodology for all aspects of a Cable Service Provider's business. Such an approach would create an un-level playing field for Cable Service Providers as they compete with non-cable providers.

The ramifications of a level playing field are most keen with respect to the development, securing and delivery of content. Careful attention must be given to make sure that the sales of content provided by one taxpayer are not subject to "special" sourcing rules, while similar content provided by a different taxpayer is subject to a "standard" sourcing regime. In defining "telecommunications service," the MTC must remain sensitive to the impact such a definition would have on the delivery of content-focused, as opposed to transmission-focused, services. The current Proposed Regulation excludes from the definition of telecommunications "the communication content of any such transmission, conveyance, routing, emission or reception." MTC Proposed Regulation §2(ii**).**

The Proposed Regulation also raises a question of level playing fields in the software arena. Cable industry participants increasingly find themselves competing in the area of software. Software used to control a digital video recorder ("DVR") is but one example of a

[9] 47 U. S. C. § 151 *et seq*.
[10] Brand X at 10.
[11] Brand X at 10.

software application sold by Cable Service Providers. Non-cable providers (*e.g.*, TiVO) also sell DVR software and compete with Cable Service Providers. The Proposed Regulation would create an environment where providers of competing technology potentially will be taxed differently.

As the technology that is used to deliver content, applications, and communications converges, providers of these services frequently find themselves challenged by new competitors. In light of this convergence, the MTC should seriously consider whether it makes sense to create special carve-outs from the general sourcing rules in such an evolving atmosphere.

If the MTC continues to lump "other similar services" in with telecommunications, the sourcing standards in the Proposed Regulations will be unworkable. The Proposed Regulation borrows heavily from telecommunications transaction-tax sourcing concepts that were adopted for purposes of non-income taxes. For example, if the service is sold on a variable unit basis, the services are sourced to the state if they originate and terminate in the state. While it will be very difficult to adapt these non-income tax concepts to income tax in the telecommunications context, it is even more difficult to adapt these concepts outside of the traditional telecommunications arena. For many providers of cable service, data processing, information services, and other services, there is no way to determine origination and termination of such services on a transactional basis.

Further, many concepts applied to transaction taxes (*e.g.*, sales tax) differ from those applied to income taxes for a variety of reasons. Transaction taxes are generally considered to be "consumption"-type taxes and as such they attempt to align the point of taxation with the point of the consumption of the item sold. Income taxes are not viewed as consumption taxes, but rather as taxes on the business activity and associated income of a taxpayer. UDITPA's adoption of a three-factor formula (the factors of which were intended to balance so-called "market state" and "production state" contributions to the generation of income) demonstrates the different theories underlying income and consumption-type taxes. It is inappropriate to apply consumption tax theories and concepts in other contexts.

CONCLUSION

These comments have identified and illustrated the following deficiencies in the MTC's Proposed Regulation:

- COP is a well-established method for sourcing receipts of all services and it reasonably reflects the Cable Service Providers' business activity;

- Only minor adjustments (not a complete overhaul) would be required to address any perceived inadequacies in the current COP rule, as applied to all services but particularly as applied to "similar services;"

- The Proposed Regulation is overly broad because it applies to any service that *may* be bundled with telecommunications service, regardless whether such bundling actually occurs;

- A variety of general policy concerns arise when transaction-tax sourcing concepts are utilized to source receipts for income tax purposes; and

- A variety of legal concerns are triggered by the MTC's Proposed Regulation.

- The various features that differentiate cable service from telecommunications service render the MTC's proposed service-address sourcing concept/rule unworkable for Cable Service Providers and other providers of "other similar services."

For all the foregoing reasons, Cable Service Providers and other providers of so-called "Similar Services" object to the inclusion of their services within the scope of the MTC's Proposed Regulation. If the MTC wishes to design a new regulation for purposes of sourcing receipts from telecommunications services, then it should cast such an effort in terms of a special Public Participation Working Group and involve all telecommunications service providers in a discourse on the propriety and efficacy of a special industry apportionment rule, such as others that the MTC has proposed (*e.g.*, the UDITPA Section 18 special apportionment rules for financial institutions and the transportation industry). If the MTC is not focused on solving a *telecommunications industry-specific* apportionment problem, then it needs to articulate its goal as being the introduction of a new apportionment rule for use by *all* service providers, regardless of industry. Once the MTC has articulated its particular concerns and identified its precise goals for this Proposed Regulation, then service providers and their representatives can meaningfully frame, understand, and participate in the discourse.